AFAANZ Grant Report 2021-2022

1. Applicants:

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2. Project Title:

Risk Factor Disclosure and Debt Contracting

3. Updated Project Summary:

One working paper was generated from this project, which is now named "Risk Factor Disclosure and Private Debt Contracting." The development of this project resulted in collaboration with one co-author, Professor Wayne Landsman. Professor Landsman is the KPMG Distinguished Professor of Accounting at the University of North Carolina and a leading accounting researcher in the world. He has published over 70 articles in leading scholarly and professional journals on topics dealing with the role of accounting information in capital price formation.

We conduct our tests using a sample of 4,769 loan packages beginning in 2005, the first year when risk factor disclosures were mandated, and ending in 2019. We find that more risk-related information content in risk disclosures, measured as disclosure length, is associated with higher loan spread and more use of collateral, income statement covenants, and non-financial covenants. These findings are also economically meaningful. For example, we find that a one-standard-deviation increase in the length of a risk factor disclosure is associated with a 12.7% increase in the loan spread and an 18.6% increase in the likelihood of a loan being backed by collateral relative to the sample mean. Further analyses suggest that this disclosure effect operates through risk-relevant information and is stronger for lenders with lower pre-deal information endowment, for disclosures that are more topically focused, and for borrowers more exposed to external risks. Lastly, we find a feedback effect of debt issuance that increases the information content of subsequent risk disclosures.

Our paper adds to the literature by showing that the risk disclosures reflect important risk dimensions relevant to private debt markets, where the usefulness of risk disclosures is less clear because lenders can require borrowers to provide information that is not publicly available. Furthermore, our findings help mitigate the concern of practitioners and regulators that risk factor disclosure is too vague and boilerplate to meaningfully reflect a firm's risks. We provide supportive evidence on the usefulness of risk disclosure, especially when the disclosure content is relevant to lenders and focused. Our study also contributes to this literature by suggesting that private lenders view the qualitative information in risk disclosure as relevant and use such information in negotiating debt contracts.

4. Funds Granted:

$7,114

5. Detailed Report on Expenditure of Funds against Budget Items, with variations explained:

A. Personnel (Research Assistant Salaries): The budget for this item is $6,314. The actual expense is $5,695.

B. Maintenance Budget: The budget for this item regarding journal submission is $2,330. The actual expense of journal submission is $1,049. An additional expense of maintenance is $370 for the software license fee, helping the research assistant to conduct the assistantship job.

Both items are expensed below the required budget because the total budget is $8,644, and the granted fund is $7,114.

6. Outcomes:

Working Paper – "Risk Factor Disclosure and Private Debt Contracting", co-authored with Wayne Landsman (please refer to the attachment for the working paper). This paper is now at a stage of second-round revise-resubmit at The Accounting Review, an Australian Business Deans Council (ABDC) A* and Financial Times (FT) 50 journal.

Abstract: This study examines the relevance of risk factor disclosures (RFDs) for private debt contracting. We hypothesize and find that the information contained in risk disclosures is positively associated with the extent to which debt contract terms are stringent regarding the pricing, collateral, and covenant provisions. Further analyses suggest that this disclosure effect operates through risk-relevant information and is stronger for lenders with lower pre-deal information endowment, for disclosures that are more topically focused, and for borrowers more exposed to external risks. Lastly, we find a feedback effect of debt issuance that increases the information content of subsequent RFDs. Our findings provide support to the SEC's amendments of Regulation S-K in 2019 that were designed to enhance the information relevance of RFDs.

7. Future Intentions for this Project:

A. Conference submission: We intend to submit the working paper to domestic and international conferences to receive helpful comments and suggestions.

B. Journal submission: We plan to re-submit the paper to The Accounting Review.

C. Grant application: We have formed a research team in the School of Accounting, Auditing, and Taxation at UNSW to submit an application for the ARC Discovery Project 2024, for which the research ideas were developed from this AFAANZ project.

D. Future project: A future project spinning off from this grant will examine whether and how ESG information is transferred across firms in the debt markets. We conjecture that lenders will be aware of the ESF risks of their corporate borrowers and therefore take actions to protect their interests.

8. Summary of Outcomes and Benefits:

Overall, we view the outcomes of the AFAANZ Grant as being very successful. The grant has generated one working paper and one future project, both with the potential of being published in leading journals and adding to the knowledge in accounting professions. It also established our research collaborations with a senior international leading accounting scholar (Professor Wayne Landsman). Finally, it encouraged our future ARC Grant Application, for which the research ideas were developed from the grant.